

**FARMERS INSURANCE EXCHANGE
P.O. BOX 2478, WILSHIRE BOULEVARD
LOS ANGELES, CALIFORNIA 90051**

NAIC COMPANY CODE 21652

**TARGETED MARKET CONDUCT EXAMINATION REPORT
AS OF MARCH 15, 2003**

EXAMINATION LOCATION

**3500 N. Nevada Avenue
Colorado Springs, Colorado, 80907**

**PREPARED BY AN INDEPENDENT CONTRACTOR FOR THE
COLORADO DEPARTMENT OF REGULATORY AGENCIES
DIVISION OF INSURANCE**

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Prepared by

Janet Sandoval

Independent Contract Examiner

May 14, 2003

The Honorable Doug Dean
Commissioner of Insurance
State of Colorado
1560 Broadway Suite 850
Denver, Colorado 80202

Commissioner Dean:

In accordance with §§ 10-1-203 and 10-3-1106, C.R.S., a targeted examination of selected underwriting and rating practices resulting from open consumer complaints of the Farmers Insurance Exchange's automobile business, has been conducted. The Company's records were examined, in part, at their home office located at 3500 N. Nevada Avenue, Colorado Springs, Colorado, 80907 and at the office of the Division of Insurance.

The examination covered the period from May 1, 2002 to March 15, 2003.

A report of the examination of the Farmers Insurance Exchange is, herein, respectfully submitted.

Janet Sandoval

Independent Market Conduct Examiner

**TARGETED MARKET CONDUCT
EXAMINATION REPORT
OF THE
FARMERS INSURANCE EXCHANGE**

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COMPANY PROFILE

Farmers Insurance Exchange, hereinafter referred to as the “the Company,” was organized on March 28, 1928, under the Reciprocal or Inter-Insurance Act of California and commenced business on April 6, 1928 with the title Farmers Automobile Inter-Insurance Exchange. The present title was adopted on May 1, 1947. The Company is currently licensed in 42 states including Colorado.

Farmers Insurance Exchange was licensed in Colorado on November 6, 1930. The Company is currently authorized to sell the following lines of business:

Fire, Marine, Surety, Disability, Plate Glass, Liability, Worker’s Compensation, Common Carrier Liability, Boiler and Machinery, Burglary, Credit, Sprinkler, Team and Vehicle, Automobile, Aircraft and Miscellaneous.

Farmers Insurance Exchange, Fire Insurance Exchange and Truck Insurance Exchange, along with their subsidiaries, comprise the Farmers Insurance Group, which is based in Los Angeles, California. The three reciprocal insurers are owned by their respective policyholders. The policyholders of each Exchange appoint an exclusive attorney-in-fact to provide management services to the Exchange.

Farmers Group, Inc., DBA Farmers Underwriters Association, is the attorney-in-fact for Farmers Insurance Exchange and the parent company of Fire Underwriters Association (attorney-in-fact of Fire Insurance Exchange) and Truck Underwriters Association (attorney-in-fact of Truck Insurance Exchange).

In 2002, the Company reported \$349,957,198 in total written premiums for all lines of insurance written out of the Colorado Springs Service Center Operations.

As of December 31, 2001, the direct written premium in Colorado for private passenger auto coverage was \$302,051,000, representing 12.01% of the market share.*

*Data as reported in the Colorado Insurance Industry Statistical Report.

PURPOSE AND SCOPE OF EXAMINATION

This targeted market conduct report was prepared by an independent examiner contracting with the Colorado Division of Insurance for the purpose of auditing certain business practices of insurers licensed to conduct the business of insurance in the State of Colorado. This procedure is in accordance with Colorado Insurance Law §10-1-204, C.R.S., which empowers the Commissioner to supplement his resources to conduct market conduct examinations. The findings in this report, including all work product developed in the production of this report, are the sole property of the Colorado Division of Insurance.

The purpose of the targeted examination was to determine the Company's compliance with Colorado insurance law and with generally accepted operating principles related to underwriting and rating practices as they related to consumer complaints for Private Passenger Automobile and Homeowners insurance. Examination information contained in this report should serve only these purposes. The conclusions and findings of this examination are public record. The preceding statements are not intended to limit or restrict the distribution of this report.

This examination was governed by, and performed in accordance with, procedures developed by the National Association of Insurance Commissioners and the Colorado Division of Insurance. In reviewing material for this report the examiners relied primarily on records and material maintained by the Company. The examination covered a period of the Company's operations, from May 1, 2002 to March 15, 2003.

File review was based on a review of consumer complaints as they related to underwriting and rating issues. Upon review of each file any concerns or discrepancies were noted delivered to the Company for review. Once the Company was advised of a finding, the Company had the opportunity to respond. For each finding the Company was requested to agree, disagree or otherwise justify the Company's noted action. The examination report is a report by exception. Therefore, much of the material reviewed is not addressed in this written report. Reference to any practices, procedures, or files, which manifested no improprieties, was omitted.

An error tolerance level of plus or minus ten dollars (\$10.00) was allowed in most cases where monetary values were involved. However, in cases where monetary values were generated by computer or other systemic methodology, a zero (\$0) tolerance level was applied in order to identify possible system errors. Additionally, a zero (\$0) tolerance level was applied in instances where there appeared to be a consistent pattern of deviation from the Company's established policies, procedures, rules and/or guidelines.

Additionally, a \$0 tolerance level was applied in instances where there appeared to be a consistent pattern of deviation from the Company's rates, on file with the Colorado Division of Insurance.

EXAMINER'S METHODOLOGY

The report deals only with underwriting and rating issues addressed in consumer complaints for Private Passenger Auto issues and contains information regarding exceptions to the Colorado Insurance Code. The examination included review of the following Company operations:

1. Underwriting and Rating Issues from Consumer Complaints

Certain unacceptable or non-complying practices may not have been discovered in the course of this examination. Additionally, findings may not be material to all areas that would serve to assist the Commissioner. Failure to identify or criticize specific Company practices does not constitute acceptance by the Colorado Division of Insurance. Examination findings may result in administrative action by the Division of Insurance.

EXAMINATION REPORT SUMMARY

The examination resulted in a total of four (4) issues arising from the Company's apparent noncompliance with Colorado statutes and regulations related to private passenger automobile insurance and use of credit information or insurance scoring.

- Failure of the Company to consistently apply Farmers Auto Risk Assessment (FARA) by changing head-of-household on an ad hoc basis resulting in "unfair discrimination."
- Failure of the Company to offer policyholders the appeal process to protest the rate increase.
- Failure of the Company to act and not implement a premium increase when the policyholder's risk assessment score is the "sole" basis for the increase.
- Failure of the Company to provide adequate FARA risk assessment score information that is clear, understandable, and transparent to Colorado policyholders when it sends "adverse" notification to policyholders.

FARMERS INSURANCE EXCHANGE

PERTINENT FACTUAL FINDINGS

TARGETED MARKET CONDUCT EXAMINATION REPORT

PRIVATE PASSENGER AUTOMOBILE

UNDERWRITING AND RATING PRACTICES

Issue A: Failure of the Company to consistently apply Farmers Auto Risk Assessment (FARA) by changing head-of-household on an ad hoc basis resulting in “unfair discrimination.”

Section 10-4-403(1), C.R.S., Standards for rates – competition – procedure – requirement for independent actuarial opinions regarding 1991 legislation, states, in part:

(c) Concerning unfair discrimination, unfair discrimination exists, if after allowing for practical limitations, price differentials fail to reflect equitably the differences in expected losses and expenses. A rate is not unfairly discriminatory solely if different premiums result for policyholders with like loss exposure but different expenses, or like expenses but different loss exposures, so long as the rate reflects the differences with reasonable accuracy. Additionally, the provision of section 10-3-1104(1)(f) shall apply.

Section 10-3-1104(1)(f), C.R.S., Unfair methods of competition and unfair or deceptive acts or practices, states, in part:

(II) Making or permitting any unfair discrimination between individuals of the same class or between neighborhoods within a municipality and of essentially the same hazard in the amount of premium, policy fees, or rates charged for any policy or contract of insurance, or in the benefits payable thereunder, or in any of the terms or conditions of such contract, or in any other manner whatever;

The Company implemented the use of Credit Scoring, known as Farmers Auto Risk Assessment (FARA) related specifically to Auto by ordering risk assessment scores on all policyholders in November 1999. Effective February 1, 2000, the Company added credit score as a factor in determining auto premiums for all policyholders. The Company states that its practice is to order new credit scores every three years on the policyholder identified as head-of-household and it allows agents to order a score every 10 months at the request of the policyholder or if the policyholder’s credit information changes.

The examiner found that for three (3) policyholders, the Company obtained FARA credit scores for the head-of-household and their spouse. It then changed the head-of-household on the three policyholders in order to provide a greater discount on their auto premiums. The Company’s business practice of changing the head-of-household, on an ad hoc basis, results in “unfair discrimination” in violation of Colorado law.

Recommendation #1:

Within thirty (30) days, the Company should provide written documentation demonstrating why the Company should not be considered in violation of Colorado Sections 10-4-403 and 10-3-1104, C.R.S.

Issue B: Failure of the Company to offer policyholders the appeal process to protest the rate increase.

Colorado Regulation 5-1-16(Section 4), Limitations on the Use of Credit Information or Insurance Scoring, states, in part:

E. Policyholder Appeal Process and Error Correction

1. If a policyholder disputes the insurer's underwriting or rating decision for renewal of motor vehicle "no-fault" insurance, the policyholder has the right to appeal under Section 10-4-720, C.R.S.

Section 10-4-720(2), Cancellation – renewal - reclassification, states, in part:

- (f) The right of the insured to protest the proposed action and request a hearing thereon before the commissioner by signing two copies of the notice and sending them to the commissioner within ten days after receipt of the notice;
- (g) That, if a protest is filed by the insured, the current insurance will remain in effect until a determination is made by the commissioner upon payment of any lawful premium due or becoming due prior to the determination;
- (h) The authority of the commissioner to award reasonable counsel fees to the insured for service rendered to the insured in connection with any such hearing if he find the proposed action of the insurer to be unjustified.

Examiner found that the Company did not offer eight (8) policyholders the opportunity to appeal the increase in premiums, upon renewal, as a result of the new FARA credit scores ordered by the Company. The Company verified that it is its business practice not to send out protest notices related to a premium increase resulting from a change in the policyholder's risk assessment score.

Recommendation #2:

Within thirty (30) days, the Company should provide written documentation demonstrating why the Company should not be considered in violation of Colorado Regulation 5-1-16 and Section 10-4-720, C.R.S.

Issue C: Failure of the Company to act and not implement a premium increase when the policyholder's risk assessment score is the "sole" basis for the increase.

Colorado Regulation 5-1-16(Section 4), Limitations on the Use of Credit Information or Insurance Scoring, states, in part:

B. Use of Consumer Reports or Insurance Scoring

1. Insurers writing personal automobile, homeowners, non-commercial dwelling fire or mobile-homeowners insurance policies in Colorado are prohibited from using credit information or insurance scoring that is:
 - b. Used as a sole basis to refuse to insure applicants, or to cancel or non-renewal existing policyholders, for rating of policies, for tier placement or to reduce coverage, without consideration of other applicable underwriting and rating factors. So long as other underwriting and rating factors are considered, offering to write a policy by an affiliated insurer with continuous coverage shall not constitute a refusal to insure.

The examiner found that seven (7) policyholders had their auto premiums increased upon renewal as a result of the FARA credit score ordered in December 2002. The FARA credit score showed a decrease in the discount from the policyholders' original risk assessment score obtained in 1999. If all other factors being applied to the rate increase are the same and the Company increased the policyholders' premiums based solely on the FARA score, the Company appears to be in violation of Colorado Regulation.

Recommendation #3:

Within thirty (30) days, the Company should provide written documentation demonstrating why the Company should not be considered in violation of Colorado Regulation 5-1-16.

Issue D: Failure of the Company to provide adequate FARA risk assessment score information that is clear, understandable, and transparent to Colorado policyholders when it sends “adverse” notification to policyholders.

Colorado Regulation 5-1-16,(Section 4), Limitations on the Use of Credit Information or Insurance Scoring, states, in part:

C. Disclosure Notice of Use of Consumer Reports or Insurance Scores

Insurers using new or updated credit information in insurance underwriting or rating shall provide a notice to applicants or policyholders specifically advising them that their credit information will be used for underwriting and/or rating. ...Upon request by applicants or policyholders, insurers or producers shall provide an explanation of significant characteristics of credit information that impact the policyholders’ insurance score. This information may be included in the disclosure form. The disclosure form shall be developed by insurers.

In addition, Federal law requires the Company to notify policyholders if an “*adverse action*” results in using credit information. The Company states that:

“Under the Fair Credit Reporting Act (FCRA), 15 U.S.C. § 1681 et seq., (hereinafter cited by reference to section numbers §§ 601-625) § 615 (b), requires Farmers to provide notice to our customers when information contained in a consumer report has had some form of adverse impact on the underwriting of their policy. Under the same act, § 603 (k) defines “adverse action” ... an increase in any charge for... any insurance....”

The Company stated that it interpreted the “adverse notification” required under Federal Law “*conservatively to mean any discount less than the best available discount.*” The examiner found that the Company’s send “adverse notification” to policyholders that received a credit score of a “B” (represents a 45 percent discount) through a “Z” (represents “0” discount). The best available discount is a 46 percent discount representing a letter “A.” Thus, the Company’s business practice is to send “adverse notification” to all policyholders that did not receive a “A” risk assessment score.

The examiner found that the Company’s business practice is not to disclose, in its adverse notification, the policyholder’s previous and current alphabetical score and related discounts. In addition, the Company does not disclose the maximum score and discount available based on the risk assessment score. As a result, without adequate risk assessment information that is clear, understandable, and transparent, Colorado policyholders cannot determine what action they will need to take in order to obtain the maximum discount available after they obtain the credit information from the consumer reporting agency.

Recommendation #4:

Within thirty (30) days, the Company should provide written documentation demonstrating why the Company should not be considered in violation of Colorado Regulation 5-1-16.

SUMMARY OF RECOMMENDATION LOCATOR
EXAMINATION REPORT ON

FARMERS INSURANCE EXCHANGE

ISSUE	RECOMMENDATION	PAGE
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Independent Market Conduct Examiner
Janet Sandoval
Participated in this examination and in the preparation of this report